



# **Report on the Audit of Financial Statements**

# INDEPENDENT AUDITOR'S REPORT

**To the Secretary**  
U.S. Department of Housing  
and Urban Development

In accordance with the Chief Financial Officers (CFO) Act of 1990, we have audited the accompanying consolidated statements of financial position of the Department of Housing and Urban Development (HUD) as of September 30, 1997 and 1996 and the related consolidated statements of operations and cash flows for the fiscal years then ended. HUD's financial statements as of September 30, 1997 and 1996 and for the fiscal years then ended, taken as a whole, were reliable in all material respects, except as discussed below<sup>1</sup>:

- **Qualification with respect to the fiscal year 1997 and 1996 financial statements: accounting standards were not followed for FHA's loan programs**

As reported in Note 2 to the financial statements, in reporting on the mortgage insurance programs of the Federal Housing Administration (FHA), HUD's principal financial statements were not prepared in accordance with the requirements of Statement of Federal Financial Accounting Standards (SFFAS) Number 2, *Accounting for Direct Loans and Loan Guarantees*. This requires that agencies estimate and report cash flows relating to loans and loan guarantee commitments made after September 30, 1991, and that such cash flows be accounted for on a present value basis. FHA's mortgage insurance programs are presented in accordance with private sector *generally accepted accounting principles* (GAAP) which significantly differ from the reporting requirements of SFFAS Number 2. FHA, as a government corporation, prepares separate financial statements in accordance with GAAP. However, the Office of Management and Budget (OMB) has determined that HUD's Department-wide financial statements are to conform with SFFAS No. 2. Because HUD had not prepared the data required for inclusion in its financial statements in sufficient time, we were unable to apply sufficient procedures with respect to such information and were unable to determine the nature and extent of any differences that would result by reporting FHA's programs in accordance with SFFAS Number 2.

- **Qualification with respect to the fiscal year 1996 financial statements: excess subsidy estimate is understated and not entirely statistically valid**

In Note 14 to the financial statements, HUD estimates that under its Section 8, Low Rent Public Housing (Operating Subsidy) and Section 202/811 Programs, \$939 million and \$538 million, plus or minus \$184 million and \$161 million, in excess rental subsidies were provided to participating households during calendar years 1996 and 1995, respectively. Under these programs, a participating household's income is a major factor affecting eligibility for, and the amount of, housing assistance a family receives, and indirectly, the amount of subsidy HUD pays. In general, HUD's subsidy payment makes up the difference between 30 percent of a household's adjusted income and the housing unit's actual rent or, under the Section 8 voucher program, a payment standard. HUD's estimate was developed in part through a review of a representative sample of households in its tenant databases. Households' income information from this sample was computer matched against federal income tax data maintained by the Social Security Administration (SSA) and Internal Revenue Service (IRS).

<sup>1</sup>This report is a condensed version of a more detailed report issued separately on March 20, 1998 by HUD, OIG entitled, "U.S. Department of Housing and Urban Development, Audit of Fiscal Year 1997 Financial Statements" (98-FO-177-0004).

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As we stated in our report dated March 21, 1997, HUD's estimate of excess subsidies that was included in the fiscal year 1996 financial statements was understated and not entirely statistically valid. With respect to the estimate included in the fiscal year 1997 financial statements, HUD addressed data limitations that we reported in our audit of the fiscal year 1996 financial statements, sufficient to provide for a reasonable estimate of the extent of excess subsidy payments. Specifically, in estimating the amount of excess rental subsidies, HUD (1) increased the number of assisted households in its tenant databases used to develop the estimate, (2) evaluated sample households whose income reported in the SSA/IRS data was from \$1,000 to \$3,000 in excess of the income reported in HUD's tenant databases and (3) included unreported income from SSA's Supplemental Security Income (SSI) program.

### Opinion on the Financial Statements

In our opinion, except for the effects of adjustments, if any, as might have been determined to be necessary had we been able to perform sufficient procedures to satisfy ourselves as to (1) the effects of not preparing financial data for FHA in accordance with SFFAS No. 2 and (2) the statistical validity of a portion of or any additional amounts with respect to the Department's estimates of excessive housing assistance reported in the fiscal year 1996 financial statements, the accompanying financial statements present fairly, in all material respects, the financial position of HUD as of September 30, 1997 and 1996 and the results of its operations and cash flows for the fiscal years then ended, in conformity with the hierarchy of accounting principles described in OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*.

### Consolidating Financial Information

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating financial information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations and cash flows of HUD's major activities. The consolidating information is not a required part of the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the consolidated financial statements and, in our opinion, except for the qualifications described above, is fairly stated, in all material respects, in relation to the consolidated financial statements taken as a whole.

### Unaudited Supplemental Information

HUD has prepared an unaudited balance sheet, statement of operations and selected footnotes as of September 30, 1997 and for the fiscal year then ended, to present FHA's financial position and selected results of operations based on the hierarchy of accounting principles described in OMB Bulletin 94-01, *Form and Content of Agency Financial Statements*, including the requirements of SFFAS No. 2. HUD is presenting this as supplemental information in this *Fiscal Year 1997 Accountability Report*. We did not audit this supplemental information and, accordingly, we do not express an opinion on it.

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Material control weaknesses affect subsidies disbursed by HUD through various programs, primarily the Section 8, Low Rent Public Housing (Operating Subsidy) and Section 202/811 Programs. As a result, HUD lacks sufficient information to ensure that federally subsidized housing units are occupied by eligible families and that those families living in such units are paying the correct rents. Existing internal controls

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and financial systems do not provide adequate assurance that funds provided to housing authorities (HA) and multifamily project owners are correctly calculated based on participating families' eligibility, and that the objectives for which funding is provided are achieved. To provide for disclosure in HUD's financial statements as of September 30, 1997 and 1996 and for the fiscal years then ended, HUD initiated special projects to estimate the amount of unreported and under reported income of participating families, and the effect on HUD subsidies. While these special projects served as a basis for determining necessary disclosure, primarily for financial reporting purposes, they were limited in scope, and have not corrected the material internal control weaknesses relating to the verification of these subsidy payments as discussed later in this report.

Our audit also disclosed:

- Material weaknesses in internal controls in fiscal year 1997 related to the need to:
  - complete improvements to financial systems;
  - improve resource management;
  - ensure that subsidies are based on correct tenant income;
  - continue efforts to improve monitoring of multifamily projects;
  - address FHA staff and administrative resource issues;
  - place more emphasis on early warning and loss prevention for FHA insured mortgages; and
  - improve FHA's accounting and financial management systems.
- Reportable conditions in internal controls in fiscal year 1997 related to the need to:
  - continue efforts to improve HUD's management control program;
  - continue efforts to develop improved performance measures;
  - continue efforts to improve the Office of Housing's subsidy payment process;
  - continue efforts to improve monitoring of HAs;
  - complete implementation of a strategy to oversee Community Planning and Development (CPD) program grantees;
  - improve general system security and other controls;
  - strengthen access controls over HUD's major payment systems, the HUD Central Accounting and Program System (HUDCAPS) and the Line of Credit and Control System (LOCCS);
  - continue actions to quickly resolve FHA's Secretary-held multifamily mortgage notes and minimize additional mortgage note assignments;
  - sufficiently monitor and account for FHA's single family property inventory; and
  - perform a review of processing controls for FHA's computer systems and place more emphasis on computer security.

Most of these control weaknesses were reported in prior efforts to audit HUD's financial statements and represent long-standing problems. In its *Fiscal Year 1996 Accountability Report*, HUD reported that it complied with Sections 2 and 4 of the Federal Managers' Financial Integrity Act (FMFIA), with the exception of the material weaknesses and nonconformances specifically identified in that report. Section 2 of FMFIA

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and related guidance generally require that an agency's internal accounting and administrative controls provide reasonable assurance that obligations and costs are in compliance with applicable laws; that funds, property and assets are adequately safeguarded; and that revenues and expenditures are properly and reliably accounted for and reported. Section 4 of FMFIA requires that accounting systems conform to the accounting principles and standards mandated by the Comptroller General of the United States. We disagreed with the Department's statement of overall assurance in the *Fiscal Year 1996 Accountability Report*. It did not fully consider the magnitude of the problems HUD acknowledges in its own FMFIA process. As was the case for fiscal year 1996, with OMB's approval as part of an initiative to streamline financial reporting, HUD did not prepare a separate FMFIA report for fiscal year 1997, but is addressing those reporting requirements in the "Financial Management Accountability Section" of this *Fiscal Year 1997 Accountability Report*. For Fiscal Year 1997, HUD reports that it complied with Sections 2 and 4 of the Act, with the exception of the material weaknesses and non-conformances specifically identified. Even though HUD has made some progress, given the magnitude of the problems that still remain, we continue to disagree with the Department's statement of overall assurance.

Our audit also disclosed the following instances of non-compliance with applicable laws and regulations:

- HUD did not substantially comply with the Federal Financial Management Improvement Act (FFMIA).
- FHA was not in full compliance with data and accounting requirements of the Credit Reform Act. Specifically, FHA's single family periodic premium collection system does not maintain case-level cash flow data required by Credit Reform. Also, FHA incorrectly paid for some contractor expenses out of financing accounts instead of using program accounts as required by Credit Reform.

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Apart from the above matters, we note that approximately \$70 billion of HUD's reported net position comprises funds appropriated to HUD to provide housing and community assistance in the future under existing commitments. As discussed in Note 3 to the financial statements, HUD entered into long-term contracts and other commitments under its various grant and subsidy programs, most significantly, the Section 8 rental assistance program. Subsequent to 1988, the Congress appropriated funds to enter into and renew multiyear contracts for the entire contract terms in the initial year of the contract, the effect of which substantially increased HUD's net position. In recent years, the terms for Section 8 contract renewals have been generally declining to the point where recent renewals have generally been for a one year term. Amounts appropriated for Section 8 contracts are based on estimated information such as household income, inflation and rent which often differ from actual information over the contract terms. To the extent that actual costs are less than amounts appropriated, reserves can accumulate. During fiscal year 1997, HUD conducted a review of the costs of the tenant-based portion of the Section 8 contract renewal program administered by the Office of Public and Indian Housing (PIH) and estimated that as of September 30, 1997, about \$9.9 billion in reserves had accumulated that was in excess of amounts needed to fund the related Section 8 contracts to their expiration dates. Pursuant to Public Law 105-18, as of September 30, 1997, HUD recaptured about \$7.7 billion of this amount of which the Congress rescinded \$3.65 billion. The remaining amount was transferred to a Congressionally mandated "Section 8 Reserve Preservation Account" for use in extending expiring Section 8 contracts.

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As further discussed in Note 3, with respect to other Section 8 programs, primarily the project-based Section 8 programs administered by the Office of Housing, a substantial number of contracts remain that were executed prior to 1988, when the Congress gave HUD the authority to enter into multiyear contracts that were not funded for their entire terms of up to 40 years. HUD then used (and continues to use) permanent indefinite appropriations to fund only the current year's portion of the multiyear contracts. Because of the duration of these contracts, substantial amounts of permanent indefinite appropriations will continue to be used in future years. Beginning in fiscal year 1988, the Congress has appropriated the funds "up-front" for the entire contract term in the initial year. HUD has determined that additional budget authority will be needed to fully fund some project-based contracts over their remaining terms because the contract authority and/or "up-front" appropriations that have been provided will not be sufficient to cover contract expenditures in a number of cases. At the time of our audit, HUD was in the process of estimating the amount of additional budget authority that will be required to fund these contracts over their remaining terms. Pursuant to Public Law 105-18, the General Accounting Office (GAO) is conducting an audit to determine whether HUD's systems for budgeting and accounting for project-based Section 8 rental assistance ensure that unexpended funds do not reach unreasonable levels and that obligations are spent in a timely manner.

In addition to the matters that are referred to in Note 11.D., HUD has resolved 18 major civil rights housing cases. In order to resolve this litigation, HUD has agreed to undertake and has undertaken various actions, some of which will necessitate the expenditure of funds in future years from various HUD appropriations. Consistent with applicable accounting principles, HUD has not recorded a liability in its financial statements because performance under the agreements will not occur until future years and most of the agreements specify that future funds are to be provided pursuant to future appropriations, in accordance with the terms of the appropriations. Moreover, HUD's ability to carry out remaining obligations is contingent on the availability of future appropriations. However, the historic source of funding for litigation related Section 8 certificates and vouchers, the Headquarters Reserve Fund [42 U.S.C., 1439 (d) (4) (A) (iii)], is not available to satisfy litigation settlements in fiscal years 1997 and 1998. Moreover, with respect to the HOPE VI program (Revitalization of Severely Distressed Public Housing), the Congress has expressly prohibited the Department, in awarding fiscal year 1997 and 1998 funds, from directly or indirectly granting a competitive advantage to settle litigation or pay judgments. The Office of Inspector General (OIG) has objected to HUD using set-asides of program funds for litigation settlements, as well as HUD's practice of awarding bonus points to applicants for settling litigation or paying judgments, on the ground that these set-asides and bonus points are not expressly permitted by statute. In addressing this issue, which we previously raised in our audit of HUD's fiscal year 1996 financial statements, HUD management advised that HUD has remaining unfunded obligations in 4 of the 18 cases and that the settlements recognize that the Congress may not provide funding. HUD management believes that should funding not be provided, the obligations may continue indefinitely or the Court may relieve HUD of its obligation, depending on the specifics of each case. With respect to future settlements, currently the Department has ongoing settlement discussions with only one case. In light of the diminished resources available for settling civil rights housing cases HUD has advised that it does not expect to enter into any settlements in which financial resources are committed, unless there is an existing appropriation under which HUD can provide funding.

Additional details on our findings regarding HUD's internal control environment, verification of subsidy payments, monitoring program recipients, and system issues are summarized below and were provided in a separate report to HUD management. These additional details also augment the discussions of instances in which HUD had not complied with applicable laws and regulations; the information regarding our audit objectives, scope, and methodology; and recommendations to HUD management resulting from our audit.



## Issues with HUD's Internal Control Environment

Fiscal year 1997 is the seventh year that HUD has been subject to audit under the provisions of the CFO Act. Most of the material weaknesses and reportable conditions discussed in this report are the same as those included in prior years' reports. HUD has been taking various actions to address the weaknesses and, in some instances, has made progress in correcting them. For the most part, however, progress has been at a slow pace in large part because HUD needs to address issues that fundamentally impact its internal control environment. HUD's ability to address its problems will substantially improve if it is successful in completing efforts to:

- upgrade its financial management systems,
- correct resource management shortcomings,
- address weaknesses with its management control program, and
- improve performance measures for its programs.

The most critical need faced by HUD in improving its control environment is to complete development of adequate systems. While HUD's efforts have met with some measurable success, much work remains and HUD continues to report material system nonconformances in this *Fiscal Year 1997 Accountability Report*. Deficiencies with HUD's financial systems are a major factor affecting our ability to efficiently audit HUD's consolidated financial statements and render an unqualified opinion on them. After investing over \$120 million on system integration projects over the last 6 years, the Department still relies mainly on legacy systems for financial management and program support. A number of critical financial management systems such as the Program Accounting System, Computerized Homes Underwriting Management System, LOCCS and others have been operational for over 15 years and are becoming increasingly difficult and costly to maintain. As part of the Secretary's *HUD 2020 Management Reform Plan (HUD 2020)*, the Department again revised its Financial Systems Integration (FSI) strategy. The *HUD 2020* plan calls for HUD to "modernize and integrate HUD's outdated financial management systems with an efficient, state-of-the-art system." The Department needs to ensure that the lack of control over project schedules and costs which has hampered the Department's ability to develop cost effective information systems in the past will not be repeated with this project. Until HUD completes the FSI plan and we have the opportunity to evaluate it and until the Department can demonstrate its ability to control performance of the implementation contractor, we remain concerned over the team's ability to exercise proper oversight over project schedules and costs.

In addition to improving its financial management systems, HUD will need to cope with inevitable staff decreases by completing development of a comprehensive strategy to manage its resources. Resource management continues to be a material weakness and the Department continues to report this as such in this *Fiscal Year 1997 Accountability Report*. In developing its latest management reform plan, *HUD 2020*, HUD did not identify resource needs based on a detailed analysis of program functions, processes and anticipated workloads. Many of the weaknesses discussed in this report, particularly those concerning HUD's monitoring of program recipients, are exacerbated by HUD's resource management shortcomings. While we agree that HUD must reform, and agree with some of the corrective measures in the *HUD 2020* plan, we generally remain cautious about the potential effectiveness of HUD's new organizational configuration, the Department's capacity to implement its planned reforms, and the potential effectiveness of many of its planned reforms.

In our separate report, we elaborate on the need for improved systems and resource management. In addition, we discuss the need for HUD to address weaknesses with its management control program and improve performance measures for its programs.

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### **Verification of Subsidy Payments**

HUD spent about \$18 billion in fiscal year 1997 to provide rent and operating subsidies to HAs and multifamily project owners that benefited over 4 million lower-income households through a variety of programs, including public housing and several variants of the Section 8 program. HUD's control structure that was in place during fiscal year 1997 did not provide reasonable assurance that these funds were expended by HAs and project owners in compliance with the laws and regulations authorizing these programs. As noted previously, HUD estimates that excess subsidy payments exceeded \$900 million for calendar year 1996. The admission of a household to these rental assistance programs and the size of the subsidy it receives depend directly on its self-reported income. HUD's control structure does not provide reasonable assurance that subsidies paid under these programs are valid and correctly calculated considering tenant incomes and contract rents.

Tenant income is a major factor affecting eligibility for, and the amount of, housing assistance a family receives, and indirectly, the amount of subsidy HUD pays. In general, HUD's subsidy payment makes up the difference between 30 percent of a household's adjusted income and the housing unit's actual rent or, under the Section 8 voucher program, a payment standard. Tenants often do not report income or under-report income from a specific source which, if not detected, causes excessive subsidy payments by HUD. As noted above, HUD has developed nationwide estimates of the amount of excess rental subsidies paid during calendar years 1996 and 1995. Various efforts are planned and underway to build upon this and address the need to institute an ongoing quality assurance program to improve controls over these payments. This includes various pilot federal income tax data matching projects. To ensure that these projects are effective, HUD needs to take action to improve the accuracy of and enforce requirements for HAs to timely update information in its tenant databases.

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### **Monitoring Program Recipients**

HUD provides grant and subsidy funds to HAs, multifamily project owners, nonprofits, and State and local governments (recipients), which, in-turn, provide housing and community development assistance to benefit primarily low income households. Weaknesses exist in HUD's control structure such that HUD cannot be assured that its funds are expended in accordance with the laws and regulations authorizing the grant and subsidy programs.

Legislation authorizing HUD's grant and subsidy programs includes specific criteria concerning tenant eligibility and allowed activities for which the funds can be expended. HUD's structure for oversight of recipients does not provide assurance that these funds are expended only on eligible tenants and allowed activities. Moreover, legislation authorizing HUD's funds also establishes minimum performance levels to be achieved with HUD funds. For example, subsidized housing must comply with HUD's housing quality standards. Here too, HUD's oversight structure does not provide it with assurance that these minimum performance levels are achieved.

Historically, HUD's oversight included the monitoring of recipients in accordance with compliance oriented procedures and frequency of reviews that applied to all recipients. In order to deal with resource limitations, in recent years, HUD has revised its monitoring strategies for its major programs to make them more risk



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based and focused on performance. We generally found that the field offices we visited were developing risk based plans for overseeing their recipients. However, we also found continuing problems, most notably with HUD's efforts to monitor multifamily projects.

Because of limitations in its ability to monitor recipients, HUD relies extensively on annual audits conducted by independent auditors (IA) pursuant to the Single Audit Act. HUD had issued revised guidance for audits of HAs to address concerns that PIH and we have had for a number of years with the quality of these audits. As with our prior audit, we reviewed IA audits performed using the revised guidance and confirmed last year's results by noting some areas of improvement over audits performed under previous guidance. However, we have identified some specific areas where the guidance needs to be improved and are encouraged by other initiatives being undertaken by PIH to increase the usefulness of these audits as monitoring tools.

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## System Issues

Because of the large volume of financial transactions, HUD relies heavily on automated information systems. In prior years, we reported on security weaknesses both in HUD's general processing controls and in specific application controls such that HUD could not be reasonably assured that assets are adequately safeguarded against waste, loss, and unauthorized use or misappropriation. Progress in improving these controls has been slow. The weaknesses noted in our current review relate to the need to improve:

- general system security and other controls and
- access controls over HUD's major payment systems, HUDCAPS and LOCCS.

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## Problems with FHA's Internal Controls Continue

In accordance with the CFO Act, a separate audit was performed of FHA's fiscal year 1997 financial statements by the independent certified public accounting firm of KPMG Peat Marwick LLP. Their report on FHA's financial statements dated March 6, 1998<sup>2</sup> includes discussions of interrelated material weaknesses that were also reported in prior audits of FHA's financial statements as follows:

- ***FHA must address staff and administrative resource issues.*** FHA must review the staffing levels, personnel skills versus skill needs, and training resources required under the current initiatives to streamline work into the single family Home Ownership Centers and to reengineer multifamily operations. These resource issues are complicated by national initiatives towards a smaller Federal government and prevent FHA from: (1) placing adequate resources on multifamily loss mitigation functions; (2) properly managing troubled multifamily assets; and (3) quickly implementing new automated systems. FHA must also address the impact on resources resulting from consolidating its nationwide single family operations into four Home Ownership Centers in fiscal year 1998.
- ***FHA must place more emphasis on early warning and loss prevention for insured mortgages.*** FHA must focus more attention on reducing the frequency and loss severity of defaults on insured mortgages by improving its efforts to identify and cure troubled multifamily mortgages before they become seriously delinquent and by utilizing loss mitigation tools for the single family insured portfolio before properties are foreclosed.

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<sup>2</sup> KPMG Peat Marwick LLP's report on FHA was incorporated in our report entitled, "Federal Housing Administration, Audit of Fiscal Year 1997 Financial Statements" (98-FO-131-0003, dated March 9, 1998).

- *Continued emphasis must be placed on improving accounting and financial management systems.* Some of FHA's automated systems either do not provide needed management information or do not produce reliable information. Better information systems for strategic decision-making would make monitoring loans more productive and staff more efficient. Improvements to the information systems are hindered because of budgetary constraints and the existence of other critical system priorities at HUD.

KPMG Peat Marwick LLP also notes three reportable conditions regarding the need for FHA to: (1) continue actions to quickly resolve multifamily Secretary-held mortgage notes and minimize additional mortgage note assignments and note servicing responsibilities, (2) sufficiently monitor and account for single family property inventory and (3) perform a review of processing controls for computer systems and place more emphasis on computer security.

KPMG Peat Marwick LLP also notes that FHA was not in full compliance with data and accounting requirements of the Credit Reform Act. Specifically, FHA's single family periodic premium collection system does not maintain case-level cash flow data required by Credit Reform. Also, FHA incorrectly paid for some contractor expenses out of financing accounts instead of using program accounts as required by Credit Reform.

We consider the above issues to be material weaknesses, reportable conditions and material noncompliance at the Departmental level. A more detailed discussion of these issues is not included in our report but can be found in KPMG Peat Marwick LLP's report on FHA's fiscal year 1997 financial statements.

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### **Additional Actions Needed**

Many of the issues described in this report represent long-standing weaknesses that will be difficult to resolve. HUD's management deficiencies have received much attention in recent years. For example, in January 1994, GAO designated HUD as a high risk area, the first time such a designation was given to a cabinet level agency. In February 1997, GAO updated their assessment but concluded that HUD's programs will remain at high risk to fraud, waste, abuse and mismanagement until it completes more of its planned corrective actions. As of the date of our current audit, GAO has not reported any changes in HUD's high risk status. A stated goal of the HUD 2020 management reform is removal of HUD from the high risk list. As we reported in last year's audit, HUD's success in meeting this goal will depend on how successful it is in (1) eliminating major internal control weaknesses, fully implementing its management control program and ensuring the proper balance between program delivery and program monitoring; (2) completing efforts to integrate its major information and financial management systems; (3) completing plans for reorganizing headquarters and field offices, including redeploying staff and consolidating program activities and similar functions; and (4) completing efforts to assess staff skills, develop appropriate training to meet certain skill needs, and increase the number of staff receiving training. As we have stated in the past, we continue to believe that while HUD can reduce staffing, HUD cannot on its own enable this reduced staff to function effectively. Congressional involvement is essential to redefine HUD's mission and programs to manageable proportions. HUD management shares this view, noting in their response to our report that HUD's ability to meet its staffing target is contingent, among other things, on the enactment of legislation by the Congress to consolidate HUD's program structure.

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## Objectives, Scope and Methodology

The accompanying financial statements are the responsibility of HUD management. Our responsibility is to express an opinion on these financial statements based on our audit. As part of our audit of the financial statements, we obtained an understanding of HUD's internal controls and assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal controls. We conducted our audit in accordance with generally accepted government auditing standards. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion on the financial statements.

We also tested HUD's compliance with laws and regulations that could have a direct and material effect on the financial statements. However, our consideration of HUD's internal controls and our testing of its compliance with laws and regulations were not designed to and did not provide sufficient evidence to express an opinion on such matters and would not necessarily disclose all matters that might be material weaknesses. Accordingly, we do not express an opinion on HUD's internal controls or on its compliance with laws and regulations.

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## Agency Comments and Our Evaluation

On February 20, 1997, we provided a draft of the internal control sections of our report to the CFO and appropriate assistant secretaries for review and comment, and requested that the CFO coordinate a Department-wide response. A draft of the remaining sections of the report was provided on March 13, 1998. The CFO responded in a memorandum dated March 19, 1998. The CFO's response, along with additional informal comments we received, were considered in preparing the final version of this report.

The Department did not disagree with most of our conclusions and recommendations, but in commenting on the material weakness relating to resource management, disagreed with our conclusion that in developing its latest management reform plan, *HUD 2020*, HUD did not identify resource needs based on a detailed analysis of program functions, processes and anticipated workloads. HUD cited an ongoing study by a management consulting firm, along with various other efforts that have been completed or are in process as HUD moves forward with implementing its management reforms.

We acknowledge that HUD is making progress and has recognized the need to make a serious effort to resolve its resource management shortcomings. However, our conclusions are based on the lack of an ongoing system that would match staff with workload, something that was not in place when the *HUD 2020* plan was first developed and continues to be lacking. Recent efforts that we have seen have been directed at justifying the existing staffing levels rather than to determine resource allocation needs. The recent consultant study mentioned in HUD's response was not provided to us because it was still in draft at the time we issued our report.

  
Susan Gaffney  
Inspector General

March 6, 1998

